SECTION IV:

OVERVIEW OF FINANCIAL PERFORMANCE: ANALYSIS AND INTERPRETATION

Overview of Financial Performance: Analysis and Interpretation

ANALYSIS OF FINANCIAL POSITION (BALANCE SHEET)

In this Accountability Report, HHS is presenting its FY 1997 (audited – consolidated) financial statements. Principal statements present information by budget function; supplemental schedules present information by OPDIV. Readers are encouraged to refer to Section V of this report for the actual financial statements and supplemental schedules, and to the HHS FY 1996 Accountability Report for FY 1996 audited (on a combining basis) financial statements.

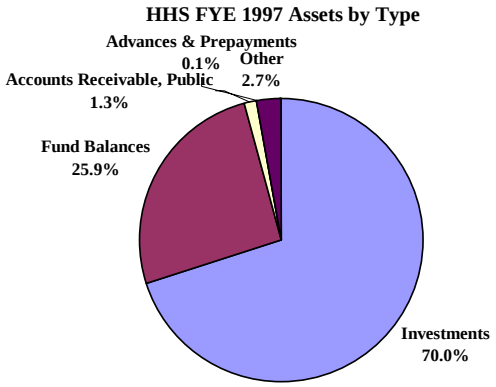
ASSETS

HHS had $217.7 billion in total assets at fiscal year end (FYE) 1997, compared to $221.6 billion at FYE 1996. This 1.8% decrease is due largely to declining balances in the Medicare Trust Funds, declining Fund Balances with Treasury at several OPDIVs, and declining Advances balances at NIH and ACF.

Assets can be analyzed by budget function, by OPDIV and by account type.

Assets Analysis by Account Type

When analyzed by account type, ***Investments*** made up 70% of total assets at FYE 1997. These investments represent the cumulative excess of collections and appropriations over expenditures of the Medicare HI and SMI trust funds, which are invested with the U.S. Treasury Special Issue Securities. (Treasury, in turn, uses these funds to finance other operations of the Federal Government thus reducing the need for Federal borrowing from the public.) These securities had been accumulating since the inception of the Medicare program (1966) until capping in 1995 when demographic shifts and high health care costs resulted in a situation where Medicare started to call upon its Trust Fund resources because annual expenditures are now exceeding revenues. Interest receivable on those trust funds represent 1.3% of HHS assets.

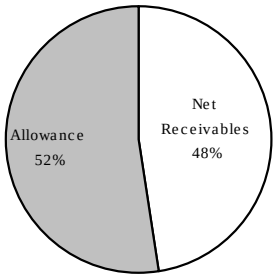


The next largest category of assets is ***Fund Balance with Treasury*** at 25.9%, which represents other undisbursed balances (largely appropriated funds, but also amounts related to revolving and other funds) held at the Treasury Department (which acts as a sort of bank for HHS).

Advances, at $239 million, makes up less than 1% of HHS assets. In FY 1996, this category had accounted for almost six percent of HHS assets and was largely attributed to NIH research grants and ACF grants to states.

Accounts Receivable from the Public (Net), at $2.916 billion, represents only 1.3% of HHS assets, but are the focus of a great deal of attention from our debt collection initiatives. Most of the receivables originated with the Medicare program. Of total gross receivables of $6.128 billion, an allowance for doubtful accounts of $3.212 (52.4%) has been established.

Receivables Due from the Public at 9/30/97



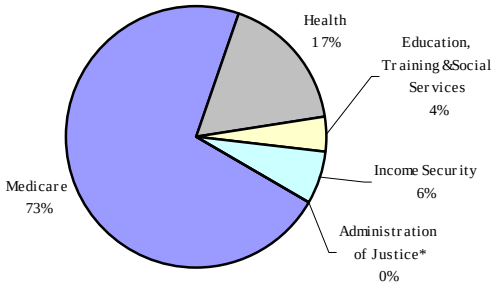
The accounts receivable from the public reported on the financial statements includes amounts accrued at fiscal year-end, which in some cases are derived from estimation processes.

Plant, Property and Equipment (PP&E), at $1.3 billion (net of accumulated depreciation), in HHS assets (.6% of total assets), and is largely concentrated at NIH (numerous high technology research centers with high technology equipment), IHS (many facilities), FDA, and CDC. In FY 1997, the capitalization threshold was increased from $5 thousand to $25 thousand. This will help reduce the burden of accounting for smaller equipment purchases.

Assets Analysis by Budget Function

When assets are analyzed by budget function, Medicare (with its own budget function category) holds the vast majority (72%) of HHS assets (composed largely of the Trust Fund account balances). The health budget function (which covers the Medicaid program, NIH, HRSA, CDC, SAMHSA, IHS, FDA and AHCPR) accounts for 17.3%, composed mostly of Fund Balances with Treasury, with lesser amounts attributed to Advances to the Public and Property and Equipment.

HHS FYE 1997 Assets by Budget Function

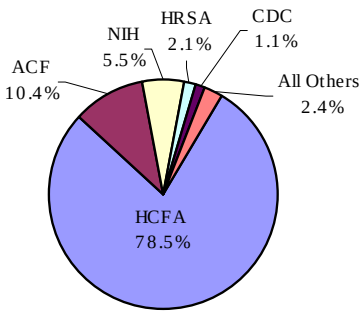


*Less than 0.1%

Assets Analysis by OPDIV

When assets are analyzed by OPDIV, HCFA accounts for 78.6% of the total, due largely to the Medicare Trust Funds and Accounts Receivable. ACF and NIH assets (at 10.4% and 5.5%, respectively) are largely concentrated in Fund Balance with Treasury.

HHS FYE 1997 Assets by OPDIV



LIABILITIES

Relative to HHS assets, there are few liabilities. This is because neither Federal law nor Federal accounting standards recognize any long term liabilities associated with covering future Medicare costs for today's workers contributing to the system who hope to become beneficiaries upon their retirement. In other words, the amount of trust fund assets accumulated over more than three decades do not have an offsetting liability for future retirees. (In FY 1998, we will continue to work with FASAB to develop the accounting standard for social insurance.)

Most of the HHS liabilities are for ***Accounts Payable*** due at fiscal year-end, typically for services provided under grants and contracts, and most are associated with the Medicare and Medicaid programs. HCFA payables amount to almost $41.8 billion is largely an estimate made up of the value of services rendered to beneficiaries as of year-end which have not yet been reported to the Medicare and Medicaid programs.

The noteworthy item in the HHS liabilities is the amount of ***Unfunded Liabilities*** (also called "liabilities not covered by budgetary resources"), which are largely unfunded pension expenses of the Commissioned Corps recognized at PSC (almost $3.3 billion), but also include accrued annual leave ($282 million) and disability compensation ($167 million) for employees at all OPDIVs. The inherent differences between the way funds are appropriated in the Federal budget process, and how they are accounted for under generally accepted accounting principles (GAAP) cause these unfunded liabilities. Budgets are formulated on more of a cash basis, while GAAP is on an accrual basis. In other words, accrual accounting recognizes that the cost of today's HHS employees consists of today's salaries and benefits actually received, as well as the accrual of benefits to be paid out at a later date (for a "full cost" amount). Budgetary accounting delays recognizing the earned but unpaid benefits for years, until the payments are actually made to the employees/retirees. The Federal budget process does not recognize the future employee benefits costs of today's employees, but instead budgets for those future expenses in the future years when they are actually paid. The result is that while employee expenses (present and future) are recognized in accrual-based financial statements, they are under-represented in the cash-based Federal budget. This is one excellent example of the benefits of accrual accounting financial statements; there are no surprises regarding liabilities for employee benefits.

NET POSITION

Net Position is the difference between total assets and total liabilities shown on the statement of financial position. Net position is further broken down into *unexpended appropriations, invested capital, cumulative results of operations*, and *future funding requirements*.

Unexpended Appropriations is the amount of authority granted by Congress that has not been expended or used. It amounted to $39.7 billion, mostly attributed to ACF and NIH.

Invested Capital of $1.7 billion (largely attributed to IHS, NIH, HRSA, FDA and CDC) represents the initial investment in a revolving fund and also the amount of funds that have been used to purchase property and equipment in all funds. Invested capital is reduced as assets are depreciated, sold, transferred to another entity or otherwise disposed of, or when a revolving fund is dissolved.

The final component of net position is ***Future Funding Requirements*** amounting to $3.7 billion. This element represents the amount of liabilities for which Congress has not yet appropriated funds. Examples include annual leave expense and pension expense for Federal employees. This amount is subtracted from net position in the statement of financial position. The amount of future funding required should generally agree with the total of unfunded liabilities reported in the liability section of the Statement of Financial Position.

ANALYSIS OF REVENUE AND FINANCING SOURCES

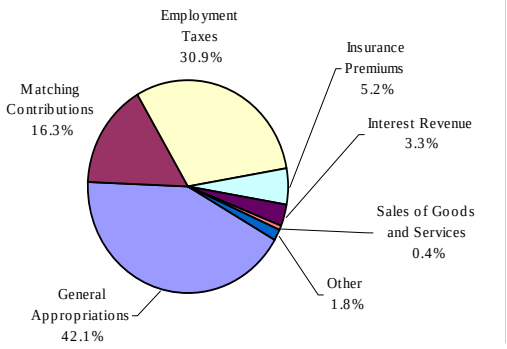
Under Federal accounting standards, Federal agency revenues include receipts from the sale of goods and services, and financing sources include appropriations. For ease of discussion, both will be referred to as "revenues."

Revenue Analysis by Account Type

HHS had three major types of revenue, displayed in the accompanying chart:

- General appropriations (42.1% of total revenue) plus matching contributions for Medicare Part B program (16.3 %) for a total of 58.4%.
- Employment taxes which help fund Medicare Part A, 30.9%.
- Insurance premiums paid by Medicare Part B enrollees, 5.2% (SMI premium).

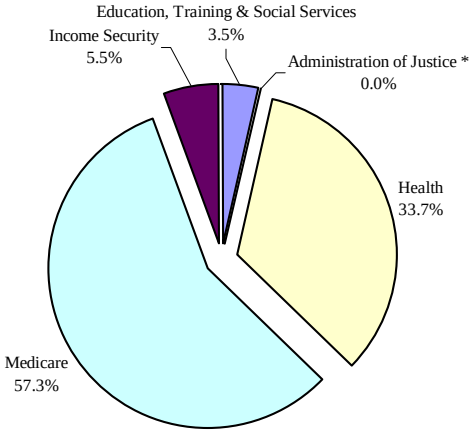
HHS FY 1997 Revenues by Type



Revenue Analysis by Budget Function

The budget functions accounting for the most revenues are Medicare and Health, respectively, where the Medicare and Medicaid programs reside. The budget function Income Security is next, due largely to appropriations used to fund the large TANF program.

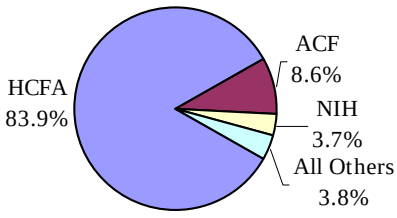
HHS FYE 1997 Revenues by Budget Function



Revenue Analysis by OPDIV

In evaluating revenue by OPDIV, HCFA accounted for 83.9 %, ACF for 8.6 %, and NIH for 3.7 %. All others combined did not exceed 3.8 %.

HHS FY 1997 Revenue by OPDIV



ANALYSIS OF EXPENSES

HHS total expenses grew approximately $9.1 billion (2.5%) from $358.2 billion in FY 1996 to $367.3 billion in FY 1997, largely due to the ever-increasing costs of Medicare and Medicaid health programs and increased research expenses at NIH.

Expense Analysis by Account Type

The two major expense categories at HHS, accounting for over 56.5 % and 39.6 %, respectively, of expenses by type are:

- *Insurance claims* under Medicare for health services provided to beneficiaries, and
- *Grants,* largely 1) for health-related research and 2) to States for Medicaid and TANF.

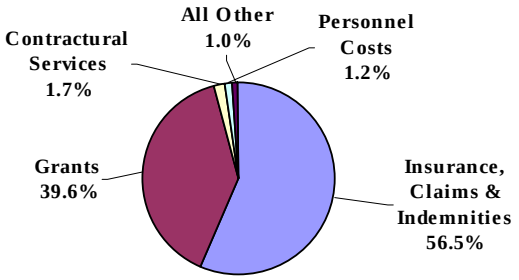
Taken alone, insurance claims and indemnities costs increased less than 1 % in FY 1997 compared to 1996. (The FY 1996 amount had increased 16.9% over FY 1995.) The 1997 amount includes an estimated $20.3 billion in errors compared to $23 billion in FY 1996. (See Sections III, V and VI for details.) Insurance claims and indemnities is the single most significant expense item to HHS, both in terms of its size and its seemingly uncontrollable rate of growth. HCFA reports that the average cost per Medicare enrollee/beneficiary increased every year since the inception of the program. With 38.6 million beneficiaries/enrollees, it is apparent that if average costs could be driven down by as little as one dollar per beneficiary/enrollee, savings of $38.6 million could result. It would only take $25.91 in annual average cost reductions to save $1 billion. Options for policy makers to consider in reducing average costs might include such things as:

- Increasing education and prevention efforts resulting in less illnesses,
- Improving fraud prevention efforts,
- Reducing the rate of exposure to environmental and other toxins,
- Researching and identifying less expensive but equally effective treatments, and
- Reducing side effects of standard treatments that must, in turn, be treated.

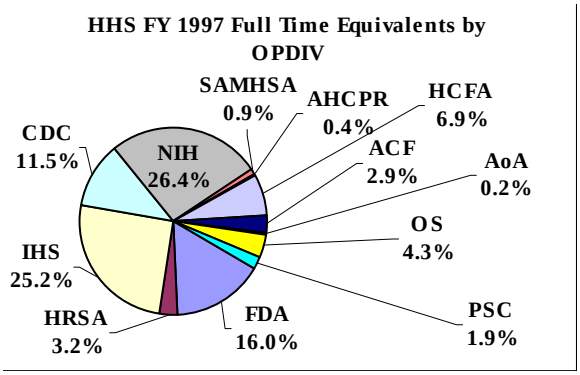
Efforts to effectively control health care costs for the long term, without threat to patient health, will require coordinated efforts of service providers, research grant administrators, researchers, insurers, educators, patients, and the Federal Government.

Grant expenses increased 6 % compared to the prior fiscal year. This is due largely to increases in Medicaid grants of over $5 billion and NIH grants of over $2.6 billion. Expenses for TANF/ACF grants actually decreased compared to FD 1996. All other expense types, including contractual services amounted to slightly over 3.9% of total FY 1997 expenses.

HHS FY 1997 Expenses by Type

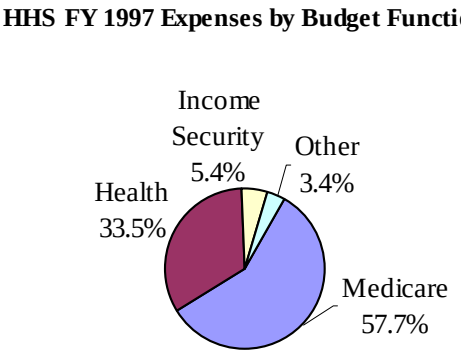


Personnel costs amount to only 1.2 % of HHS FY 1997 expenses. Employment levels at the OPDIVs do not follow the same pattern as expenditures or net outlays. For example, HCFA makes up 85% of the HHS budget, but has only 6.9 % of HHS employees. Conversely, IHS has 25.1 % of the HHS employees, but only 0.6% of the HHS budget. Some OPDIVs are more employee-intensive than others depending on the amount of work performed by contractors and whether or not expense categories include large amounts of entitlement payments and grant awards. Employment of full time equivalents (FTEs) is illustrated in the accompanying pie chart.



Expense Analysis by Budget Function

Analyzed by budget function, most expenses are in the Medicare (57.7 % of total expenses) and Health (33.5 %) functions, due to the Medicare and Medicaid programs. The next largest budget function expense category is Income Security (5.4 %), where the TANF program resides.



Expense Analysis by OPDIV

When expenses are analyzed by OPDIV, the results follow the same pattern as do revenues: HCFA (Medicare and Medicaid) accounts for the vast majority (84%) of expenses, followed by ACF (TANF and other programs) and NIH (research).